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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR NORTH TEXAS DISTRICT COUNSEL
CC:MSR:NTX:DAL

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS:P&SI

SUBJECT: ; Request for Field Service Advice

This Field Service Advice responds to your memorandum dated October 15, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =

Y =

Z =

A =

B =

C =

ISSUE(S):
What litigation hazards exist in asserting that machines which are held in storage for future installation have not been “placed in service” allowing depreciation deductions to begin?

FACTS:

Currently this non-docketed case is in appeals jurisdiction which is considering a settlement offer by the taxpayer.

The issue arises in connection with the audit of the above taxpayer for the **A** and **B** taxable years. **X** a subsidiary of the above taxpayer is engaged in the transportation, purchase and sale of natural gas. **X** owns and operates a **Z** mile integrated pipeline system which connects gas supply sources from several states to natural gas markets in several other states.

During the time period of the mid **C**'s, **X** anticipated a substantial growth in its gas markets and an extension of its gas lines. Additional compressors would be required to maintain gas pressure in the new and existing lines as the expansion progressed. Consequently, **X** bought new and used compressors for future use. These machines were repaired if necessary and placed into warehouses for storage until needed for future expansion projects.

Upon completion of any necessary repairs and delivery to storage, **X** treated the compressor as having been "placed in service" for depreciation purposes notwithstanding that the compressors were not yet installed in a pipeline. The compressors were often held in storage for over a year and longer. Taxpayer represents that, typically, it took two days to install a compressor when the related pipeline was ready.

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LAW AND ANALYSIS

Internal Revenue Code section 167(a) provides that a depreciation deduction is allowed for property used in the taxpayer's trade or business or for property held for the production of income. Treasury Regulation 1.167(a)(10) provides that the period for depreciation begins when the asset is "placed in service." Treas. Reg. § 1.167(a)-11(e)(1)(i) states that property is first placed in service for purposes of the depreciation deduction when it is "placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity."

The Service has applied the regulation to generally require actual operational use in the trade or business. See Consumers Power Co. v. Commissioner, 89 T.C. 710 (1987); Oglethorpe Power Corp. v. Commissioner, T.C. Memo. 1990-505; 60 T.C.M. (CCH) 850 (1990).

In Consumers, the Tax Court found that an electricity generating unit was not placed in service in 1972, the year for which the taxpayer had claimed depreciation deductions and investment tax credits. In that year, the unit had not yet completed the preoperational testing phase required by the Federal Power Commission and had not been formally accepted by the operator from the subcontractor. The court also observed that even though the unit had generated electrical power during the testing phase in 1972, the amount of electrical power generated was "insufficient to establish that the ... [p]lant was available for full operation on a regular basis in 1972." Id. At 724. It concluded that the unit was not in a state of readiness and availability for its specifically assigned function. Although, this quoted clause was not the exclusive grounds for the holding, in referring to the small amount of power output as support for its conclusion, the court implicitly adopted the argument that the unit was not placed in service in 1972 because it did not show sustained, regular generation of electrical power.

Relying on Consumers, the court in Oglethorpe stated that an electricity generating unit was not deemed to be placed in service in 1981 because it was not available for its specifically assigned function, which the court defined as consistently sustaining generation levels near its rated capacity. Oglethorpe, 60 T.C.M. (CCH) 850 at 859.

The Service has taken a slightly less restrictive approach relating to “full operation at rated capacity” as a prerequisite for an asset being placed in service when electricity is generated continuously at lower levels as part of a gradual increase over time of energy production levels. *See, e.g.,* Rev. Rul. 84-85, 1984-1 C.B. 10 (stating that although another Revenue Ruling found taxpayer's facility had been placed in service when it was able to operate at rated capacity without failure, this level of operation was not a prerequisite but merely a fact demonstrative of operational status). See also Sealy Power v. Commissioner, 46 F.3d 382 (5th Cir. 1995) (minimal operation of an electricity generating plant fueled by burning trash is sufficient for plant to be deemed placed in service). However, Service position has generally been that actual operational use is a prerequisite for an asset being deemed “placed in service” subject to exceptions set forth in regulations (discussed infra).

Similarly, the system in which machinery in used must be operating before that machinery may be considered placed in service. For instance, in Consumers Power, supra, the upper reservoir component of a pumped storage hydroelectric plant could not be considered placed in service until the entire plant was placed in service because the reservoir and physical plant operated as one integrated unit to produce electrical power. 89 T.C. at 725-26. Similarly, in Siskiyou Communications, Inc. v. Commissioner, 60 T.C.M. (CCH) 475, 478-79 (1990), telephone switching equipment and toll carriers were not considered placed in service even though capable of performing individual functions because wiring for

the systems in which they were to operate had not been completed and employees had not been trained to use the equipment. See also Hawaiian Indep. Refinery, Inc. v. U.S., 697 F.2d 1063, 1069 (Fed. Cir. 1983)(two offsite components not considered separately from refinery in considering in determining applicable construction date because all were designed as a single unit and together they functionally formed a single property); Public Service Co. v. U.S., 431 F.2d 980, 983-984 (10th Cir. 1970).

Two cases appear to contradict the "actual use" general requirement. Northern States Power Company v. United States, 151 F.3d 876 (8th Cir, 1998) and Connecticut Yankee Atomic Power Co. v. United States, 97-2 USTC ¶ 50,693 (Ct. Cl. 1997). In both cases the courts allowed depreciation for nuclear fuel assemblies in the year received. The courts reasoned that they were "ready and available" for immediate use upon delivery, as part of periodic refueling of operating nuclear power generating plants. The fuel assemblies were not actually installed in and supplying power to the reactors until months after delivery in the following fiscal year. Installation took slightly over a month in Northern States and several months in Connecticut Yankee (due to unusual problems).

Thus, the Court of Federal Claims and the Eighth Circuit rejected an "actual operation" requirement in this context. These cases arguably merely extend the example in the regulations allowing immediate depreciation for spare parts of operating machinery.[1] The opinions, however, do not appear to limit themselves as merely falling under the exceptions, and, at least in this context, seem to adopt an expansive "available for use" standard. Northern States, supra at 892 ; Connecticut Yankee, supra at 89,768.

Other allegedly contrary authority is not on point. In Waddell v. Commissioner, 86 T.C. 848 (1986) rental equipment was deemed placed in service in a rental trade or business when the equipment was first available for lease. Id. At 898. There

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[1]Treas. Reg. § 1.46-3(d)(2)(ii) sets forth an example allowing depreciation for spare parts ready and available for operating machinery. Unlike the regulatory example, however, the assemblies were not acquired as spares to avoid operational time loss in the event of an unplanned malfunction. See Rev. Rul. 81-185, 1981-2 C.B. 59. The regulation also sets forth an example allowing depreciation for a fully operational farm tractor acquired too late in the fall to be used until the following spring. See also Sears v. Commissioner, 359 F.2d 191 (2nd Cir. 1991) which allowed depreciation for an otherwise fully operational barge that could not be currently used due to an uncontrollable fact of nature, i.e., a frozen canal. To similar effect see SMC Corporation v. Commissioner, 82-1 USTC ¶ 9309 (6th Cir. 1982)(fully operational shredder and crane deemed placed in service when only electrical connection remained to be completed).

was no requirement that the rental company operate the equipment it was leasing since rental rather than physical operation was its function from the perspective of the rental company. Id. Similarly, depreciation was not claimed in Piggly Wiggly v. Commissioner, 84 T.C. 739 (1985) until the years in which the equipment was actually installed and used. Id. at 747.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

If you have any further questions, please call the branch telephone number.

DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service)

By: _____
WILLIAM C. SABIN, JR.
Senior Technician Reviewer
Passthroughs & Special Industries Branch